IT 05-0046-GIL 10/26/2005 APPORTIONMENT – SALES FACTOR

General Information Letter: The numerator of the sales factor of a service provider is determined by sourcing each sale separately according to the income-producing activities related to that sale, not by using the aggregate activities for all sales.

October 26, 2005

Dear:

This is in response to your letter dated October 5, 2004, in which you request advice. Department of Revenue ("Department") regulations require that the Department issue only two types of letter rulings, Private Letter Rulings ("PLRs") and General Information Letters ("GILs"). PLRs are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. GILs do not constitute statements of agency policy that apply, interpret or prescribe the tax laws and are not binding on the Department. For your general information, the regulation governing the issuance of letter rulings, 2 Ill. Adm. Code Part 1200 regarding rulings and other information issued by the Department, can be accessed at the Department's website. That address is www.revenue.state.il.us/legalinformation/regs/part1200.

In this instance, you have specifically requested a GIL. In your letter you state as follows:

> In accordance with 86 Ill. Admin. Code Section 1200.120, we are requesting a general information letter ("GIL") regarding our client's ("Company X") sales factor for the purpose of calculating Company X's Illinois apportionment factor pursuant to 35 ILCS 5/304. In the event that the Department of Revenue ("Department") intends to either deny issuance of the requested GIL or render an unfavorable ruling, we respectfully request to be notified before the issuance of said GIL and be given an opportunity to discuss the issues and/or provide any additional facts.
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> **ISSUE:**
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> To what extent should Company X, an internet marketer, include advertising receipts derived from internet advertising services in the numerator of its Illinois sales apportionment factor?
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> **FACTS:**
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> Company X, a California corporation, is headquartered in CITY1, California. Company X is a leader in online behavioral marketing, publishing and advertising messages over the internet for top tier companies and agencies. Unlike traditional demographic marketing, Company X's behavioral marketing model combines powerful insights into consumer behavior and the ability to deliver contextually relevant advertisements to a targeted market. The relevancy of the messages attracts 'click through' and increases conversion rates considerably higher than traditional banner ads. As a result, Company X's clients realize an unprecedented boost in the results of their advertising campaigns.
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> Fees for these advertising services are determined according to one of the following pricing methods:

Cost Per Impression: The advertiser pays a specified amount for each time the ad is displayed on a user's computer screen;

Click: The advertiser pays for each time a user activates a hyperlink embedded in the advertisement and is taken to a website determined by the advertiser;

Transaction: The advertiser pays Company X fees based on advertising conversions – for instance, each time an Internet user applies for a credit card with an advertiser (also referred to as 'success-based advertising.')

In addition to Company X's corporate headquarters in CITY1, California, Company X maintains offices in CITY2, CITY3, CITY4 and CITY5. In each of these cities, Company X maintains sales representatives and account managers. The sales representatives solicit advertisement services to customers on the internet that have local, regional and national presence. The account managers service the advertisers that utilize Company X's services.

Company X paid approximately $71,000 in rent associated with its property located in Illinois for the year ended December 31, 2004. Company X employees resident in Illinois earned wages totaling approximately $1,730,000 in the year ending December 31, 2004. Company X's Illinois operations consist of client service, sales and marketing personnel.

In CITY1, California, Company X employs all of the company's technology personnel that develop the software and other computer technology support necessary to run the software applications that ultimately enable Company X to advertise on the internet.

Company X maintains three locations where internet information is routed on computer servers. Two of these centers are in California and the third center is in CITY2. The internet trafficking data is not specific to any advertiser, market or client, but rather by random 'round robin' allocation between Corporation (sic) X's three different locations in order to balance loads between the three sites. In other words, any given advertising campaign will have approximately 1/3 of its traffic hosted through the CITY2 location center at random.

Company X incurred approximately $13,000,000 in costs to maintain network, data center operations and technical support personnel, servers and network equipment hosting services, depreciation and amortization expense for servers, storage and network equipment and repair and maintenance costs. Collectively these costs are referred to as 'Cost of Revenue'. Of the $13,000,000 Cost of Revenue incurred in 2004, approximately $1,250,000 was incurred directly in Illinois or is otherwise indirectly attributable to Illinois operations. The remaining $11,750,000 was incurred at Company X's locations in CITY1, California.

Conclusion

Illinois source sales of advertising based on the cost of producing the advertising service inclusive of the core activities of the advertiser integral to the delivery of the advertisements. In Company X's instance, the 'Cost of Revenue' directly incurred in Illinois should constitute the direct costs determined in accordance with generally accepted accounting principles ($1,250,000). Company X's 'Cost of Revenue' from its CITY1 and other California operations should also be considered in computing Company X's direct costs determined in accordance with generally accepted accounting principles ($11,750,000).

Accordingly, in applying the cost of performance to Company X's income producing activities, a greater proportion of the costs are performed outside of Illinois. Even if one were to include the cost to maintain the client service and sales and marketing personnel in CITY2 as direct cost, a greater proportion of Company X's Illinois costs are performed outside of Illinois. As a result, Company X's Illinois sales factor apportionment numerator should be zero.

RELEVANT AUTHORITY:

Illinois statutes and regulations do not specifically address sourcing of advertising receipts derived from displaying internet advertisements for Illinois sales factor and apportionment computation purposes.

Sourcing of receipts derived from sales other than that of tangible personal property based on the cost of performing the income producing activity

Illinois Income Tax Act ('IITA') Section 304 generally provides that the sales factor is a fraction, the numerator of which is the total sales of the person in Illinois during the taxable year, and the denominator of which is the total sales of the person everywhere during the taxable year. IITA Section 304(a)(3)(A). IITA Section 304 further provides that sales other than of tangible property are in Illinois if the greater proportion of the income-producing activity is performed within Illinois than without Illinois, based on cost of performance. IITA Section 304(a)(3)(C).

Defining 'income producing activity' and 'cost of performance'

Illinois regulations further define 'income-producing activity' and 'cost of performance' in the context of IITA Section 304(a)(3)(C). 86 Ill. Adm. Code Section 100.3370(c)(3)(A) & (B). An 'income-producing activity' is defined as the 'transactions and activity directly engaged in by the persons in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit.' 86 Ill. Adm. Code Section 100.3370(c)(3)(A). The definition of 'income-producing activity' also includes, but is not limited to, the 'rendering of personal services by employees or the utilization of tangible and intangible property by the persons performing the service.'

According to 86 Ill. Adm. Code Section 100.3370(c)(3)(D)(iii) ' gross receipts for the performance of personal services are attributable to this State to the extent such services are performed partly within and without this State, the gross receipts for the performance of such services shall be attributable to this State only if a greater portion of such services were performed in this State, based on the cost of performance.'

Additionally, this regulation also defines ‘costs of performance’ as ‘direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade of business of the person.’

ANALYSIS:

Company X’s activities are so integral as to constitute a single income producing activity

The routing of advertising traffic is not specific to any advertiser, market or client service group, and traffic is randomly routed. The routing of advertising traffic by Company X cannot be deemed to be a separate income producing activity in Illinois. It also follows that Company X’s gathering of behavioral data, necessary in producing relevant, targeted internet advertising, should be deemed an integral income producing activity. Similarly Company X’s operation and maintenance of out-of-state data centers are integral and necessary to its advertising operations given the high volume of advertising traffic and the resulting trafficking patterns.

Company X should include the costs of out-of-state location in calculating the cost of performance

Company X may properly include the costs of operating out-of-state data centers, and the technology support to those data centers as well as the Illinois-based data center in determining the cost of performance as it relates to advertising income producing activities.

Application of the ‘cost performance’ provision to the income producing activity of Company X

Under IITA Section 304, Company X should include advertising receipts, a service, in the numerator of its sales factor only if the greater proportion of the income producing activity is performed within Illinois based on the cost of performance. Company X engages in the trade or business of online behavioral marketing and internet advertising.86 Ill. Adm. Code 100.3370 provides that ‘income producing activity’ applies to each separate item of income, including the rendering of services by employees. As discussed above, Company X’s activities are dependant on and part and parcel to the delivery of relevant internet advertising. Ultimately the cost of performing this activity in Illinois, relative to other states, will determine whether these activities are deemed to occur in Illinois.

Company X calculates its cost of performance by determining the direct costs, in accordance with generally accepted accounting principles. In Company X’s instance, the ‘Cost of Revenue’ directly incurred in Illinois should constitute the direct costs determined in accordance with generally accepted accounting principles ($1,250,000). Company X’s ‘Cost of Revenue’ from its CITY1 and other California locations should constitute its direct costs determined in accordance with generally accepted accounting principles ($11,750,000).

Even if one were to include the cost to maintain the client service and sales and marketing personnel in CITY2 as direct cost, a greater proportion of Company X's costs are performed outside of Illinois. As a result, Company X's Illinois sales factor apportionment numerator should be zero.

SUMMARY:

Illinois sources sales of advertising based on the cost of producing the advertising service inclusive of the core activities of the advertiser integral to the delivery of the advertisements. In applying the costs of performance to Company X's income producing activities, a greater proportion of the costs are performed outside of Illinois than in Illinois. As a result, Company X's Illinois sales factor apportionment numerator should be zero.

RESPONSE:

You have correctly cited the applicable law regarding apportionment of business receipts from the sale of services generated by income-producing activity based upon costs of performance. This method, however, is applied on a sale-by-sale basis, not against the aggregate of sales for a given taxable year. Otherwise, Illinois' current use of a single-factor sales apportionment formula would result in an all-or-nothing approach for most taxpayers deriving multi-state income. Thus, the information provided is inadequate to determine the percentage of business income from any particular sale or client to include in the numerator of Company X's sales factor based upon comparative costs of performance.

As stated above, this is a GIL which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you wish to obtain a PLR which will bind the Department with respect to the application of the law to specific facts, please submit a request conforming to the requirements of 2 Ill. Adm. Code Part 1200.

Sincerely yours,

Jackson E. Donley,
Senior Counsel-Income Tax